

No. 14903

United States
Court of Appeals
for the Ninth Circuit

THE BANK OF ARIZONA, a Corporation,
Appellant,

vs.

NATIONAL SURETY CORPORATION, a Corpora-
tion,
Appellee.

BRIEF FOR APPELLANT

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Appeal from the United States District Court for the
District of Arizona

FILE

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OPINION BELOW

The Findings of Fact and Conclusions of Law of the District Court appear at pages 47-55 of the Transcript of Record.¹

1. References to the printed record are designated as "R"

JURISDICTION

The jurisdiction of the District Court was invoked under Act June 25, 1948, c. 646; 62 Stat. 930; 28 U. S. C. A. 1332. Appellee, National Surety Corporation, a New York corporation brought suit against Appellant and others in the United States District Court for the District of Arizona, alleging: Appellant was an Arizona banking corporation; defendant Food Machinery and Chemical Corporation was a Delaware corporation; defendants B. Harlan Fike and Marvin F. Gordon were citizens of the State of Arizona; defendants Babbitt Brothers Trading Company and Flagstaff Lumber Company were Arizona corporations, and that the amount in controversy exceeded the sum of \$3,000, exclusive of interest and costs. (R 3, 4).

The Findings of Fact of the District Court confirmed these jurisdictional allegations (R 48-49). The final judgment of the District Court was entered on July 15, 1955 (R 56-59); the Appellant's Notice of Appeal to this Court of Appeals from a portion of the final Judgment was filed August 4, 1955. The jurisdiction of this Court is invoked under Act June 25, 1948, c. 646; 62 Stat. 929; 28 U.S.C.A. 1291.

QUESTIONS PRESENTED

Whether a Surety can create for itself, under a theory of subrogation, rights which its purported subrogor did not have.

Whether a compensated Surety has in its own right, without benefit of assignment or subrogation, an equitable lien on the proceeds of a government contract which

will permit it, upon payment of the penalty under its payment bond, to recover the loss from any person who has received any of the contract proceeds with knowledge that the laborers and material men were not paid in full at the time the moneys having their source in the contract were paid to him.

STATUTES INVOLVED

The pertinent portions of the statutes involved are set out in the Appendix, *infra*.

STATEMENT

On June 18, 1952, the Dollar Construction Company (hereinafter referred to as "Contractor") entered into a Contract with the Government (hereinafter referred to as "Contract") whereby it agreed to perform certain work at the Navajo Ordnance Depot, Bellemont, Arizona (hereinafter referred to as the "Navajo Job"), in consideration for which the Government agreed to pay Contractor the sum of \$12,180.00, (later increased by a Change Order to \$12,580.00), in a lump sum on the completion of the job. (R 49)

The Contract required the Contractor to furnish to the Government a Performance Bond and a Payment Bond. (R 49).

The Contract contained no express provision for the payment by Contractor to persons who furnished labor and materials and contained no provision for retained percentages. (R 49)

In conformity with the requirements of Act August 24, 1935, c. 642, section 1; 49 Stat. 793 (40 U.S.C.A. 270)

(hereinafter referred to as the “Miller Act”) and the provisions of the Contract, Contractor furnished and Government accepted and approved a Performance Bond and a Payment Bond, in the penal sum of \$6,-090.00 each, executed in Arizona on June 18, 1952, by Contractor and Appellee (hereinafter referred to as “Surety”). (R 49, 50).

The Payment Bond¹ was conditioned that Contractor should promptly make payment to all persons supplying labor and materials in the prosecution of the work provided in the Contract. (R 50).

The Performance Bond² was conditioned that Contractor should perform the Contract.

As a condition precedent to and as part of the consideration for the execution of the Performance Bond and the Payment Bond, Contractor executed and delivered to Surety an “Application for Contract Bond” (R 50, 127-130).

Surety is not a bank, trust company or other financing institution. Surety gave no notice of the above referred to Bond Application to any person or agency as required by the Assignment of Claims Act 1940, as amended, 31 U.S. C. A.203 ; 41 U. S. C. A. 15, Appendix, *Infra*, and its contents were not known to Bank until the commencement of this action. (R-50)

The Food Machinery and Chemical Corporation and B. Harlan Fike (hereinafter referred to as “Material-

1. U.S. Standard form 25A, see Section 54.16 Appendix, Title 41, U.S.C.A. p. 256.

2. U.S. Standard form 25, see Section 54.15 Appendix, Title 41, U.S.C.A. p. 249.

men'') each supplied labor and materials to Contractor on the Navajo Job, in the respective sums of \$8,644.40 and \$3,579.60 (R 50). The Navajo Job was completed by Contractor on October 20, 1952 (R 51) and was certified by the Government as meeting the plans and specifications of the Contract (R 191, 192). At the time of completion the above mentioned sums were due and owing to the Materialmen, no portion thereof having been paid. (R 51).

On October 22, 1952, the Contractor procured a loan from Appellant (hereinafter referred to as "Bank") in the principal sum of \$10,000.00, in consideration for which Contractor executed an Assignment to Bank of the proceeds of the Contract. (R 51)

The entire loan proceeds were deposited to the credit of Contractor's then and theretofore existing general checking account with the Bank. (R 51)

At the time the loan was made by Bank, the Bank ascertained from the contracting officer at the Navajo Ordnance Depot that the Contract had been completed and that the proceeds of the Contract were shortly forthcoming. (R 51, 107, 108)

At the time the loan was made the Contractor had had an account with the Bank for a month or two. (R 150). The Bank knew Contractor had several jobs going (R 150) and that it was having the common difficulty of many Contractors of getting its money in from jobs to continue its operations. (R 141). This difficulty arose not from a matter of insolvency but from a shortage of the Contractor's operating cash. (R 142, 149, 155). At

the time the loan was made Bank was told by Contractor the money was needed to pay up the laborers and materialmen on the Navajo Job. Bank did not know, nor did it ascertain how much of the loan would be needed for that purpose (R 136-137, 142)

The Bank ascertained prior to making the Loan that the Contractor had furnished a Payment Bond, although the Bank had no actual knowledge of the identity of the surety on the bond. (R 51, 52).

The contracting officer at the Navajo Ordnance Depot approved and accepted the Assignment to Bank on October 22, 1952. (R 185, 187)

On or about December 9, 1952, the Bank delivered a formal written notice of the assignment to the Government contracting officer at the Navajo Ordnance Depot (R 111, 112, 184, 185), mailed a notice of the assignment together with a true copy of the instrument of assignment to the Surety (R 188, 189), which notice was received by the Surety on December 10, 1952 (R 52). Surety's notice was forwarded in the same form as the notice to the contracting officer (R 184, 185). Surety, however, returned its notice to the Bank with a form of acceptance which it prepared (R 96, 189) with a letter of transmittal explaining the revision. (R 187). The receipt of this form of acceptance subsequent to December 23, 1952, was the first knowledge Bank had of contractor's default.

Bank also filed with the United States Army Finance Officer at Los Angeles, the disbursing officer designated in the Contract to make payment, a copy of the as-

signment, together with the notice of assignment. (R 118, 119, 190, 191). These instruments were received by the Finance Officer on December 11, 1952 (R 119). The Government check in the sum of \$12,580.00, the proceeds of the Contract, was issued December 12, 1952, and received by Bank on December 15, 1952. (R 53, 121)

On receipt of the check the Bank applied \$10,139.51 of the Contract proceeds in satisfaction of the Contractor's loan obligation to the Bank. At the time the proceeds were applied, the Bank knew that the Contractor had not paid all Materialmen. Upon demand of surety a Cashier's check payable to Contractor for the remaining balance of the Contract proceeds, \$2,440.49, was mailed to Surety and was thereupon endorsed specially by Contractor to Fike. (R 53)

On April 23, 1953, Surety commenced an action in the District Court by filing a complaint later amended on July 15, 1954, against Bank and the five materialmen who had made claims against Surety on its Payment Bond. The original aggregate of these claims was \$12,438.12. The claim of Fike was reduced by the application of the balance of the Contract proceeds by \$2,440.49, leaving the aggregate of unpaid materialmen claims totaling \$9,997.63. (R 7)

Concurrently with the filing of the complaint Surety deposited with the Clerk of the District Court the sum of \$6,090.00 representing the full penalty of the above mentioned Payment Bond. (R 53) This sum was alleged as not being sufficient in amount to pay all per-

sons who supplied labor and material in the prosecution of the work provided for in the contract, but it was alleged that sum theretofore applied by the Bank to the payment of its note was more than sufficient to discharge the unpaid obligations (R 10)

The Bank was alleged in Surety's complaint as owing the materialmen the sum of \$9,997.63 for money had and received from the United States of America. (R 11)

The complaint of the Surety set up a purported assignment to Surety contained in the Contract Bond Application of Contractor (R 5, 6) and alleged the Bank knew or should have known of the purported prior assignment of the contract proceeds to Surety at the time Bank took this Assignment. (R 7, 8) Surety further alleged Bank knew or should have know that Surety was entitled to exoneration from its obligations to pay for labor and material and was entitled to subrogation and to a prior right in and claim to the contract funds. (R 8)

The relief sought by the Surety was: (1) that the materialmen be required to interplead and litigate their rights against Surety and Bank (R 11); (2) that the Court adjudge and direct the return to the plaintiff of the \$6,090 deposit with the Clerk of the District Court (R 11); (3) that the Court adjudge and decree that the Bank pay into Court the sum of \$10,139.50 received by it and that the Court adjudge and direct that upon the receipt of the same the Clerk pay the materialmen and disburse the remainder to the Bank (R 11, 12), (4) the alternative relief prayed was that in the event the sum of \$6,090 be not returned to the Surety, the Surety have and recover from the Bank that sum. (R 12)

The answer of the Bank, by the second defense, placed in issue the purported Assignment of the contract proceeds to Surety (R 13) and the amounts due to the materialmen. (R 14)

Bank admitted its loan to the Contractor and the Assignment to Bank and alleged such Assignment as being received in good faith, without notice, and permitted and perfected under the Assignment of Claims Act, 1940, as amended. (R 14, 15)

Bank denied the notice of and the existence of any rights of Surety by subrogation or exoneration. (R 16)

The defendant Food Machinery filed a cross-claim against defendant Fike asserting a right to share in the \$2440.49 of the contract proceeds paid to Fike; Food Machinery cross-claimed against Bank seeking satisfaction in full of its claim of \$8644.40, and further counter-claimed against Surety for the same relief. Defendant Fike also filed a counter-claim against Surety seeking recovery of the balance of its claim of \$1139.11. The Court rendered judgment that the Bank and Fike have judgment on the cross-claim of Food Machinery; that Fike and Food Machinery have judgment on their counter-claims against Surety in the respective sums of \$708.88 and \$5,381.12, and that the Surety have judgment against the Bank of Arizona in the sum of \$6090. (R 56-59)

SPECIFICATIONS OF ERROR

The District Court erred:

1. In making that portion of Finding of Fact No. 5 (R 50) which legally construed the Contractor's Bond application (R 127-130) as having the effect of an assignment

“ . . . to indemnify Surety for any liability Surety might incur by reason of having executed . . . the Payment Bond.”

because such Finding was an erroneous conclusion of law, for the reason that the application (R 127-130) has the legal effect of an assignment to indemnify Surety only for any liability Surety might incur by reason of having executed the Performance Bond.

2. In making that portion of Finding of Fact No. 11 (R 52)

“ At the time the loan was made by Bank and the assignment to it was executed, Bank, in the exercise of reasonable care and diligence, should have known: . . .

(c) the proceeds of the Contract then in the hands of the Government were inchoately subject to an equity in favor of Surety in that if Surety was required to pay the materialmen who the Contractor failed to pay, then Surety would become subrogated to the right of the Government to have the Contract proceeds applied in payment of the Materialmen, and that right would relate back to the date of the Payment Bond.”

for the reason that the Finding is an erroneous conclusion of law in that it places a legal duty upon the Bank to have known that which neither existed by reason of fact or law.

3. In making that portion of its first Conclusion of Law (R 53-54) that

“The failure of Contractor on and prior to October 20, 1952, or at all, to make payment to persons supplying labor and materials in the prosecution of the work provided in the Contract rendered the Contractor in default under the provisions of the Contract . . . ;”

because the conclusion that a default occurred under the provisions of the Contract is not sustained by the Findings of Fact and is contrary to the fact found, (Finding No. 3, R 49) that

“The Contract contained no express provision for the payment by Contractor to persons who furnished labor and materials and contained no provision for retained percentages.”

4. In making that portion of its first Conclusion of Law (R 54) that

“. . . by the payment into Court by Surety of \$6,-090.00 which was the full amount of its penalty under the Payment Bond, Surety became subrogated to the right of the Government to have the Contract proceeds applied in payment of the Materialmen, said right of subrogation relates back to the date of the Payment Bond, June 18, 1952”

for the reason that the payment of the Contract proceeds by Government to Bank terminated any rights of

the Government to the proceeds or the application thereof, which rights could not be revived to enforce restitution, refund or repayment to the United States of the money paid to Bank, an assignee under an assignment perfected under the Assignment of Claims Act of 1940 as amended.

5. In making its second Conclusion of Law (R 54) that the

“Contractor held its right to the proceeds of the Contract, subject to an equitable lien in favor of Surety; when it transferred its right to Bank, Bank took the proceeds of the Contract subject to Surety’s equitable lien”.

for the following reasons:

a. The facts do not justify a conclusion that an “equitable lien” arose by subrogation of Surety either to the rights of the Government or to the rights of the Materialmen because the Materialmen had no rights in fact or law to which the Surety could be subrogated to as determined by the Court in its Conclusion of Law No. VII, (R 55) that

“The Materialmen have no equitable, legal or moral right against Bank or to the Contract proceeds which were paid by Government to Bank.”

and because the Government’s rights were terminated upon payment

b. The facts do not justify a conclusion that an “equitable lien” arose from the Contractor’s application to Surety (R 127-130) because the instrument effected an assignment by Contractor to Surety of only

such moneys that might be due and payable at the time of any breach or default in the Contract for the purpose of indemnifying Surety for any liability Surety might incur by reason of having executed the Performance Bond and in fact no breach or default in the Contract ever occurred and Surety incurred no liability under the Performance Bond.

c. The Bank purchased its assignment of the Contract proceeds for value, in good faith, without notice of the contents or existence of the Application for Contract bond, perfected its Assignment under the Assignment of Claims Act of 1940, as amended, and received payment thereunder.

d. Surety has no "equitable lien" to the Contract proceeds without reliance upon a theory of subrogation or assignment.

6. In making its 6th Conclusion of Law (R 55) that

"Surety is entitled to judgment against Bank for the sum of \$6,090.00"

for the reason that the Conclusions of Law supporting this ultimate conclusion are erroneous and not supported by the facts as found.

7. In entering that portion of the Judgment appealed (R 59)

"4. That plaintiff National Surety Corporation have judgment on its amended complaint against the defendant, The Bank of Arizona, in the sum of \$6,090.00"

for the reason that the facts do not justify such judgment and it is contrary to law.

SUMMARY OF ARGUMENT

Surety acquired no rights against Bank by subrogation to the rights of either the Materialmen or the Government. The Materialmen never had any rights against the Bank to which the Surety could become subrogated. *California Bank v. United States Fidelity & Guaranty Co.*, 129 F. 2d 751. Though the government may recognize a moral obligation to see that the unpaid reserves of the Contract price held by the government as a stakeholder are applied to the claims of unpaid materialmen and may assert a right to see that they are so applied, nevertheless, upon the payment of the fund all rights and duties of the government in the fund cease. *California Bank v. United States Fidelity & Guaranty Co.*, 129 F. 2d 751, *Kane v. First National Bank*, 56 F. 2d 534, 85 A.L.R. 362, *Royal Indemnity Co. v. United States*, 93 F. Supp. 891. The moneys due under the Contract which were assigned to Bank pursuant to the Assignment of Claims Act, having been received by the Bank under the assignment, were free of any right on the part of the government, Act. May 15, 1951, c. 75; 65 Stat. 41, amending the Assignment of Claims Act of 1940, 31 U.S.C.A. 203, 41 U.S.C.A. 15. One can not acquire by subrogation what another whose rights he claims did not have. *U.S. v. Munsey Trust Co.* 332 U.S. 234, 67 S. Ct. 1599, 91 L. Ed. 2022. The extinguishment of the right of the subrogor extinguishes the same right for the subrogee. *National Surety v. Pixton*, 60 Utah 289, 208 Pac. 24 A.L.R. 1487.

Surety acquired no rights to the Contract proceeds by assignment. The assignment to Surety contained in

the bond application was to indemnify Surety only for any liability Surety might incur by reason of having executed the Performance Bond and the moneys assigned for this indemnification were such as might be due at the time of a default in the Contract. Therefore, since Contractor did not default on its Performance Bond, the assignment did not become effective as to any of the Contract proceeds.

Surety has no equitable lien on the Contract proceeds in its own rights. If the government contract proceeds are subject to a continuing equitable lien in favor of Surety which follows the proceeds even after payment, the rule must rest upon the theory that the compensated Surety has this equitable lien in its own right and not dependent upon subrogation or assignment. The authorities implying a lien or the imposition of a trust upon the Contract proceeds rely upon facts giving rise to rights of Surety by subrogation, where the unexpended funds are in the hands of the government. *Henningesen v. United States Fidelity & Guaranty Co.*, 208 U.S. 404, 28 S. Ct. 389, 32 L. Ed. 547; *Royal Indemnity Co. v. United States*, 93 F. Supp. 891; *Hadden v. United States*, 132 F. Supp. 202; *National Surety Co. v. United States*, 133 F. Supp. 381. or depend upon a known assignment to Surety of the Contract proceeds where the funds are paid out. *Martin v. National Surety Co.* 300 U.S. 588, 57 S. Ct. 531, 81 L. Ed. 822, *Pacific Indemnity Co. v. Grand Avenue State Bank of Dallas*, 233 F. 2d 513. The former class of cases where the fund is held by the government, are inapplicable; the latter class of cases, imposing a trust or lien upon the Contract funds

after payment, have no application where assignee of the Contractor purchases his assignment for value, in good faith, without notice of a prior assignment, and obtains payment. *McKenzie v. Irving Trust Co.*, 323 U.S. 365, 65 S. Ct. 405, 89 L. Ed. 305; *California Bank v. United States Fidelity & Guaranty Co.*, 129 F. 2d 751; *Kane v. First National Bank*, 56 F. 2d 534, 85 A. L. R. 362; *Fidelity & Deposit Co. v. Union State Bank*, 21 F. 2d 102; *Restatement of Contracts*, Section 173-b and 174.

ARGUMENT

POINT ONE

SURETY ACQUIRED NO RIGHTS AGAINST BANK BY SUBROGATION TO THE RIGHTS OF EITHER THE MATERIALMEN OR THE GOVERNMENT

The Materialmen never had any rights against the Bank to which the Surety could become subrogated.

*California Bank v. United States
Fidelity & Guaranty Co. (C.C.A. 9th,
1942)
129 F. 2d 751, 753.*

The District Court properly entered its seventh Conclusion of Law (R 55) that:

“The materialmen have no equitable, legal or moral right against Bank or to the contract proceeds which were paid by Government to Bank.”

and properly gave judgment to Bank on the cross-claim of materialman Food Chemical, that the cross-com-

plainant take nothing from defendant Bank. by its claim. (R 59)

Though the government may recognize a moral obligation to see that the unpaid reserves of the contract price held by the government as a stakeholder are applied to the claims of unpaid materialmen and may assert a right to see that they are so applied, nevertheless, upon the payment of the fund all rights and duties of the government in the fund cease.

California Bank v. United States
Fidelity & Guaranty Co.
129 F. 2d 751

Kane v. First National Bank
(C.C.A. 5th, 1932)
56 F. 2d 534
85 A. L. R. 362

Royal Indemnity Co. v. United States
93 F. Supp. 891

Subsequent to the performance of the Contract, i.e., at a time when no default of Contractor under its government contract could occur, the Contractor assigned the Contract proceeds to Bank. Bank is of the class of permitted assignees under the Assignment of Claims Act of 1940, as amended, 31 U.S.C.A. 203, 41 U.S.C.A. 15, Appendix, *infra*. Prior to the payment by Government of the Contract proceeds, Bank complied with the requirement of the Assignment of Claims Act by filing written notice of the assignment, together with a true copy of the instrument of assignment with the contracting officer, the Surety and the disbursing officer.

It is not necessary to determine on the facts of this case whether the Bank's assignment, permitted and perfected under the Assignment of Claim Act of 1940, would have given it a preferred right over the right of the government to apply the funds to the payment of materialmen, had the funds been held in the hands of the government, because the funds were in fact paid to Bank. The conflict of the decisions of the United States Court of Claims in

Royal Indemnity Co. v. United States
93 F. Supp. 891

Hadden v. United States
132 F. Supp. 202

National Surety Corporation
v. United States
133 F. Supp. 381

on this point and the decisions of the Court of Appeals, Fifth Circuit, in

Cocoanut Grove Exchange Bank v.
New Amsterdam Casualty Co.
149 F. 2d 73

General Casualty Co. v. Second
National Bank of Houston
178 F. 2d 679.

arise upon the factual situation of those cases where the funds are yet held by the government as a stakeholder.

In the instant case, payment was made by the issuance of a Government check in the sum of \$12,580, the full Contract price, on December 12, 1952 (R 121), which check was received by the Bank on December 15,

1952, and used to the extent necessary to satisfy the Contractor's debt to Bank. (R 53)

These moneys due under the Contract which had been assigned pursuant to the Assignment of Claims Act having been received by the Bank under the Assignment, were free of any right on the part of the government by the express provisions of Act May 15, 1951, c. 75, 65. Stat. 41, amending the Assignment of Claims Act of 1940, 31 U.S.C.A. 203, 41 U.S.C.A. 15:

“In any case in which moneys due or to become due under any contract are or have been assigned pursuant to this section, no liability of any nature of the assignor to the United States or any department or agency thereof, whether arising from or independently of such contract, shall create or impose any liability on the part of the assignee to make restitution, refund, or repayment to the United States of any amount heretofore since July 1, 1950, or hereafter received under the assignment.”

Since neither the Materialmen nor the Government had any rights against the Bank or to the fund paid to it, Surety could acquire no rights by subrogation to the position of the Materialmen or the Government.

“It is elementary that one can not acquire by subrogation what another whose rights he claims did not have . . . One who rests on subrogation stands in the place of one whose claims he has paid as if the payment giving rise to the subrogation had not been made.”

U. S. v. Munsey Trust Co.
332 US. 234, 242
67 S. Ct. 1599
91 L. Ed. 2022, 2029

Surety could not revive, by later payment, a right which its subrogor could not revive. The extinguishment of the right of the subrogor extinguishes the same right for the subrogee. In the case of

National Surety v. Pixton
60 Utah 289
208 Pac. 878
24 ALR 1487, 1494

the Court held that by the enactment of a statute which gave up the preferential right the State might have to bank deposits, upon the deposit by the State of its funds, the surety on the bank's deposit bond, in the event of default and payment by surety, was effectively foreclosed from being subrogated to the preferential right the State might otherwise have had.

POINT TWO

SURETY ACQUIRED NO RIGHTS TO THE CONTRACT PROCEEDS BY ASSIGNMENT.

The Miller Act, Act Aug. 24, 1935, c. 642, sec. 1; 49 Stat. 793; 40 U.S.C.A. 270a requires two separate bonds on a government contract job, a performance bond for the protection of the government and a payment bond for the protection of the materialmen.

Prior to the enactment of the Miller Act, 40 U.S.C.A. 270¹ had provided for only one bond to secure both the payment and performance. The distinction between the purpose and the effect of the two bonds is well defined.

Where, as here, the contract makes no express provision for the payment of laborers and materialmen, (R 49), a public contractor's bond for the performance of the contract does not inure to the benefit of laborers and materialmen and consequently there is no loss to surety under the performance bond for unpaid claims of persons who supply labor and materials. The authorities are collected in 77 A.L.R. 105 and 118 A.L.R. 75. Since the contract was completed and the work certified as having met plans and specifications of the contract (R 51, 191-192) no liability of Surety ever arose under its Performance Bond and no breach or default in the Contract ever occurred.

Surety claimed a purported assignment of the Contract proceeds in its amended Complaint (R 5-6) as resting upon the Contractor's covenants and agree-

1. Based on Aug. 13, 1894 c. 280, 28 Stat. 278; Feb. 24, 1905, c. 778, 33 Stat. 811; Mar. 3, 1911, c. 231, Section 291, 36 Stat. 1167.

ments as set forth in paragraphs 4th and 7th of an application which was allegedly required and received by Surety as a condition precedent and as a part of the consideration for Surety executing a Performance Bond and a Payment Bond. The application is reproduced on pages 127-130 of the printed record.

The application is a printed form of the Surety Company which has been artfully and tediously drawn in detail, with the obvious purpose of giving legal efficacy to its language. The form as completed is the application of the Contractor of June 20, 1952, that Surety executed a bond in the sum of \$12,180 in favor of the United States, the principal object of such bond being to

“guarantee the performance of a certain contract” as thereafter described. In the blanks following, the Contract is identified as the Navajo Job Contract, payment to be made on completion with no reserve.

A reading of the entire application shows that the form contemplated the issuance by the Surety of a bond to guarantee to the Treasurer of the United States the performance of the Contract and the protection of Surety for its obligations under such a Performance Bond. No reference is made to the issuance of a Payment Bond or to the protection of Surety in its obligations under a Payment Bond.

The language of “said bond” or the “bond hereinabove applied for” appears throughout the application as very clearly applying to one bond only. The application was not meant to cover and affect the relation of the parties in respect to other than a single Perform-

ance Bond, otherwise the application would have meticulously specified the singular and plural of the word "bond" in the method used in specifying the singular, plural and gender of other words.¹

The entire indemnity provisions of paragraph fourth (R 5-6, 129) are to indemnify Surety for executing the bond to "guarantee the performance of the Contract".

Under paragraph sixth of the application (R 129) the only conditions upon which Surety may assert its right of foreclosure of its security, in the paragraph specified for indemnity, are the "default on the part of the undersigned in the performance of the Contract hereinabove referred to", and the non-payment of premiums.

Paragraph seventh (R 129) purports to provide additional security for the indemnification of Surety. Consistently with the entire instrument, "the deferred payments and retained percentages and any and all moneys and properties that may be due and payable" to the Contractor which are assigned to Surety for its indemnification, are those which are due and payable to the Contractor "*at the time of any breach or default in said Contract, or that thereafter may become due and payable*" to the Contractor.

1. The consideration clause: (R 129): "The undersigned and each of them for himself (itself), his (its) . . .". Paragraph 4: (R 129) ". . . or any unpaid bond premium(s) . . . in enforcing any covenant(s) of this agreement . . ." Paragraph 11: (R 129) ". . . at the address(es) . . ." Paragraph 19: (R 130) ". . . any provision(s) of any law(s) concerning the disclosure(s) . . ." Paragraph 20 (R 130) ". . . that he (they) is (are) entitled . . ."

The District Court properly refused to make Finding 10(j) proposed by Surety (R 25) that at the time the loan was made by Bank and the assignment to it was executed, Bank knew, or in the exercise of reasonable care and diligence should have known: “. . . (j) Contractor had previously assigned the proceeds of the Government Contract to Surety.” The District Court further properly refused to enter the first and second conclusions of law proposed by Surety (R 26) “I. At the time Contractor assigned the proceeds of the Contract to Bank there existed a valid prior assignment of the Contract proceeds by Contractor to Surety. II. The rights of Surety under the prior assignment are superior to the rights of Bank which procured the execution of the subsequent assignment and received the proceeds of the Contract with notice of the prior assignment and rights of Surety.”.

The question of priority of an assignment to Bank and an assignment to Surety does not arise, since Surety in fact and in law had no assignment of the Contract proceeds.

The Contractor's application to Surety is digested with pertinent parts in a parallel comparison with the application of the Contractor to the United States Fidelity and Guaranty Co. in *California Bank v. United States Fidelity & Guaranty Co.* 129 F. 2d 751. This comparison is for the purpose of illustrating the difference between a form prepared to indemnity surety for both bonds as in the *California Bank Case* and the form of application now before this Court.

POINT THREE

SURETY HAS NO EQUITABLE LIEN ON THE CONTRACT PROCEEDS IN ITS OWN RIGHTS.

If the Conclusion of the District Court is correct that the government contract proceeds are subject to a continuing equitable lien in favor of Surety which follows the proceeds even after payment, it must rest upon the theory that the compensated Surety has this equitable lien in its own right and not dependent upon subrogation or assignment.

If such a lien exists, it must then be founded upon the particular facts of this case. The fact that the recipient of the funds is a bank should not control, and the case must be considered in the light of the rights of any creditor receiving the government contract proceeds with knowledge of their source. Knowing the source of the money, the creditor is bound to know that the Miller Act has required the Contractor to execute a Performance Bond, which bond must, according to law, provide for the protection of laborers and materialmen; the creditor is bound to know that if the laborers and materialmen are not paid the Surety must pay them; therefore the creditor must ascertain at his peril whether or not there are any outstanding obligations of the Contractor to the laborers and materialmen before accepting payment, else he assumes the obligations of the compensated Surety to the extent of the payment received.

There is, however, no authority for the existence of an equity of Surety in the Contract proceeds paid to Bank upon the facts in this case. The authorities using language implying a lien or the imposition of a trust upon the Contract proceeds rely upon facts giving rise to rights of Surety by subrogation, where the unexpended funds are in the hands of the government

Henningsen v. United States
Fidelity & Guaranty Co.
208 U.S. 404
28 S. Ct. 389
52 L. Ed. 547

Royal Indemnity Co.
v. United States
93 F. Supp. 891

Hadden v. United States
(U.S. Ct. of Claims, 1955)
132 F. Supp. 202

National Surety Co. v. United States
(U.S. Ct. of Claims, 1955)
133 F. Supp. 381

or depend upon a known assignment to Surety of the Contract proceeds where the funds are paid out.

Martin v. National Surety Co.
300 U. S. 588
57 S. Ct. 531
81 L. Ed. 822

Pacific Indemnity Co. v. Grand Avenue
State Bank of Dallas
C.C.A. 5th, 1955
(233 F. 2d 513)

The former class of cases resting upon subrogation,

where the fund is held by the government, is inapplicable; the latter class of cases imposing a trust upon the Contract funds after payment by the government must be examined upon the facts of each case.

In

Martin v. National Surety Co.
300 U.S. 588
57 S. Ct. 531
81 L. Ed. 822

the holding of the Court that the funds paid to a creditor were impressed with a trust in favor of the materialmen was based upon the narrow ground chosen by the Court, page 593, 300 U.S. that:

“The proceeds of the contract when collected by Martin (the creditor) under his power of attorney were received by him with knowledge of the agreement between the contractor and the surety whereby such proceeds became a fund to be devoted in the first instance to the payment of materialmen and others similarly situated.”

The “agreement” known to the creditor was the contents of the bond application which the creditor, as agent for the surety, had himself personally accepted. The creditor further had actual knowledge of a power of attorney solicited by the surety from the contractor to protect itself after the difficulties of the contractor became known to surety and creditor. The entire determination of the equities impressed on the fund arose from the knowledge of the specific agreement which was determined by the Court to have created an equitable

lien when the subject matter of the assignment was reduced to the possession and was in the hands of the contractor or persons claiming under him, with notice.

The Supreme Court of the United States later distinguished the facts of the Martin case from the situation where a subsequent assignee takes without notice of the prior assignment to surety. The Court said, in

McKenzie v. Irving Trust Co.
323 U.S. 365, 372-3
65 S. Ct. 405
89 L. Ed. 305, 310-311

“In any event the affidavits fail to establish the asserted priority of the surety over respondent (bank). The surety did not perfect its assignment¹ by giving the notices and procuring the consent required by the statute (Assignment of Claims Act of 1940). It did not receive the proceeds of the contract here in question. They were paid to respondent which does not appear to have had any notice of the prior assignment to the surety. Under the Federal rule respondent is entitled to retain the assigned moneys which it received without notice of the prior assignment to surety. (Citations). The Martin case does not control here since the subsequent assignee in that case took with notice of an early assignment and as part of an obviously fraudulent scheme. These facts which were sufficient in that case to require that the subsequent assignee relinquish the transferred funds are lacking here.”

1. The assignment to the bank in McKenzie v. Irving Trust Co., was perfected under the Assignment of Claims Act of 1940, 323 US 368.

The recent decision of the Court of Appeals, 5th Circuit, in

*Pacific Indemnity Co. v. Grand
Avenue State Bank of Dallas*
223 F. 2d, 513

was determined upon a theory that the funds received by the bank in payment of the contractor's debt were impressed with a trust for surety's benefit. The trust arose by virtue of the specific agreement between contractor and surety contained in contractor's application and the declared default of contractor whereupon surety had taken over the contract. Prior to the bank's charging the contractor's account in satisfaction of the contractor's debt to it, the surety commenced an action in the state court against contractor wherein a temporary restraining order was issued restraining the contractor from disposing of funds in the contractor's possession as proceeds of the construction contract. Though the bank was not a party to this action, a copy of the restraining order was served upon it and from this service it had, as in the Martin case, actual knowledge of the trust claimed by surety by virtue of its agreement with contractor and the declared default of contractor. With knowledge of these facts, the bank inquired of the contractor of its condition and upon being advised that it was insolvent, the bank then charged contractor's account. The issue in the case was whether the bank's lack of notice at the time it received the government check for deposit should control over the bank's actual knowledge of the trust at the time of payment.

Other cases in which the contract proceeds were paid

out fail to impose a constructive lien or to impress a trust where the recipient of the money has no notice of the agreement between surety and contractor.

In

Kane v. First National Bank
C.C.A. 5th 1932
56 F. 2d 534, 535-536
85 A.L.R. 362, 365

the bank received on deposit, for contractor, moneys which the bank knew were in partial payment from a public contract. Upon the contractor advising the bank of its inability to continue in business, bank charged the account in payment of the contractor's debts to the bank. The Court, in ruling that the bonding surety on the public job had no claim to the contract proceeds paid to the bank, said:

“In the absence of statute or stipulation otherwise. the general responsibility of the contractor is credited in contracting with him and his general resources are drawn on by him in executing the contract. Money or checks paid to him as the work progresses are the property of the contractor unencumbered by any trust, just as are the payments to others for goods manufactured or services performed. The contractor's banker may receive such checks and is not bound to see to their application, nor to ascertain the state of the contractor's account with each contract; nor if he knows it need he govern himself in any wise with reference thereto.”

See also:

Fidelity & Deposit Co. v. Union
State Bank
21 F. 2d. 102

In the case at bar, at the time the loan was made and the assignment accepted, Bank had no knowledge of the purported assignment by Contractor to Surety. (R 50). It will be noted that the essential fact indicating to Bank any default of Contractor was that all of the Materialmen had not been paid. Bank did not know the nature or extent of the unpaid bills and made no effort to find out. Surety, however, would place a duty upon Bank to ascertain the indebtedness of Contractor on the job and determine from what it discovers whether or not Contractor is in default under the Payment Bond. If Surety is successful in imposing this duty upon creditors of Contractor, it will effect upon the Contract proceeds a continuing lien relieving sureties of their payment bond obligations, because their rights will no longer be limited to the reserves in the hands of the government; by invoking the doctrine of relation, their rights of subrogation may always be revived. Contractors are constantly indebted to laborers and materialmen through the entire progress of a job and usually for periods of varying lengths following the completion of a job. If the contractor's indebtedness is a caveat to all persons who take his money in exchange for fair consideration, the practices of commerce and the principles of commercial law will have to undergo considerable revision. The holding of

California Bank v. United States
Fidelity & Guaranty Co.
129 F. 2d 751

will be overruled by this Court.

In the "California Bank Case" the contractor received payment from the government contract in the sum of \$28,815.04 on June 30, 1933, and bank accepted payment of contractor's debt to it on the same day, knowing the source of the money. At the time he received the \$28,815.04, the contractor owed that amount, and more, to persons supplying labor and material in the prosecution of the work. The bank received payment, however, without knowing of the assignment to surety of the contract proceeds; bank first learned of the assignment on July 19, 1938, nineteen days after it had received payment. The existing indebtedness of contractor at the time of payment was not notice of default by the holding of this Court.

The facts of the case at bar are parallel, with the exception that here the bank did not learn of the purported assignment to Surety until the commencement of this action (R 50) in April, 1953, and did not learn of the default of Contractor until subsequent to December 23, 1952, more than eight days after payment to Bank (R 187-189, 53). It is submitted that the rule applied in the California Bank case, at page 755 of 129 F. 2d is applicable to the facts of this case, that:

"The doctrine of relation cannot be used by a subrogee for the purpose of recovering money paid to a creditor without notice in satisfaction of a just

debt, prior to the maturing of any right of subrogation.”

It is further submitted that the dictum of the California Bank case preceding the above quoted passage relative to the exclusion of an assignee of the contractor from the rule is not applicable where the assignee purchases his assignment for value in good faith without notice of a prior assignment and obtains payment or satisfaction of the obligor's duty.

Restatement of Contracts
Sections 173-b and 174

Collins v. O'Connell
(C.C.A., 1943)
136 F. 2d 141, 143 (re Arizona
Authority of Restatement)

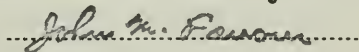
McKenzie v. Irving Trust Co.
323 U.S. 365
65 S. Ct. 405
89 L. Ed. 305

CONCLUSION

For the reasons stated the portion of the judgment appealed should be reversed and the amended complaint of Appellee dismissed as to Appellant, with costs to Appellant.

Respectfully submitted,

FAVOUR AND QUAIL



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February 1956

APPENDIX A

PUBLIC CONTRACTS
ASSIGNMENT STATUTES

I

ASSIGNMENT STATUTES IN FORCE PRIOR TO OCTOBER 9, 1940, THE DATE OF ENACTMENT OF THE ASSIGNMENT OF CLAIMS ACT OF 1940.

R.S. Section 3477.

“All transfers and assignments made of any claim upon the United States, or of any part or share thereof, or interest therein, whether absolute or conditional, and whatever may be the consideration therefor, and all powers of attorney, orders or other authorities for receiving payment of any such claim, or of any part, or share thereof (with inapplicable exceptions), shall be absolutely null and void, unless they are freely made and executed in the presence of at least two attesting witnesses, after the allowance of such a claim, the ascertainment of the amount due, and the issuing of a warrant for the payment thereof . . .”

R. S. Section 3737

“No contract or order, or any interest therein, shall be transferred by the party to whom such contract or order is given to any other party, and any such transfer shall cause the annulment of the contract or order transferred, so far as the United States are concerned. All rights of action, however, for

any breach of such contract by the contracting parties, are reserved to the United States.”

II

ASSIGNMENT STATUTES EFFECTIVE SUBSEQUENT TO OCTOBER 9, 1940 AND PRIOR TO MAY 15, 1951.

R. S. Sections 3477 and 3737 were amended by the addition of the following language by the Assignment of Claims Act of 1940, Act of October 9, 1940, c. 779, Section 1; 54 Stat. 1029 (31 U.S.C.A. 203; 41 U.S.C.A. 15) :

“The provisions of the preceding paragraph shall not apply in any case in which the moneys due or to become due from the United States or from any agency or department thereof, under a contract providing for payments aggregating \$1,000 or more, are assigned to a bank, trust company or other financing institution, including any Federal lending agency: *Provided* 1. That in the case of any contract entered into prior to October 9, 1940, no claim shall be assigned without the consent of the head of the department or agency concerned; 2. That in the case of any contract entered into after October 9, 1940, no claim shall be assigned if it arises under a contract which forbids such assignment; 3. That unless otherwise expressly permitted by such contract any such assignment shall cover all amounts payable under such contract and not already paid, shall not be made to more than one party, and shall not be subject to further assignment, except that any such assignment may be made

to one party as agent or trustee for two or more parties participating in such financing; 4. That in the event of any such assignment, the assignee thereof shall file written notice of the assignment together with a true copy of the instrument of assignment with—(a) the General Accounting Office, (b) the contracting officer or the head of his department or agency, (c) the surety or sureties upon the bond or bonds, if any, in connection with such contract, and (d) the disbursing officer, if any, designated in such contract to make payment. Notwithstanding any law to the contrary governing the validity of assignments, any assignment pursuant to this paragraph and the following paragraph shall constitute a valid assignment for all purposes.

Any contract entered into by the War Department or the Navy Department may provide that payments to an assignee of any claim arising under such contract shall not be subject to reduction or set-off, and if it is so provided in such contract, such payments shall not be subject to reduction or set-off for any indebtedness of the assignor to the United States arising independently of such contract.”

III

ASSIGNMENT STATUTES EFFECTIVE SINCE MAY 15, 1951.

R. S. Sections 3477 and 3737 as amended by Assignment of Claims Act of 1940 were further amended by

Act May 15, 1951, c. 75; 65 Stat. 41; (31 U.S.C.A. 203; 41 U.S.C.A. 15) to strike out all after clause 3 of the proviso and inserting in lieu thereof the following:

“4. That in the event of any such assignment, the assignee thereof shall file written notice of the assignment together with a true copy of the instrument of assignment with (a) the contracting officer or the head of his department or agency; (b) the surety or sureties upon the bond or bonds, if any, in connection with such contract; and (c) the disbursing officer, if any, designated in such contract to make payment.

Notwithstanding any law to the contrary governing the validity of assignments, any assignment pursuant to this section, shall constitute a valid assignment for all purposes.

In any case in which moneys due or to become due under any contract are or have been assigned pursuant to this section, no liability of any nature of the assignor to the United States or any department or agency thereof, whether arising from or independently of such contract, shall create or impose any liability on the part of the assignee to make restitution, refund, or repayment to the United States of any amount heretofore since July 1, 1950, or hereafter received under the assignment . . .”

APPENDIX B

COMPARISON OF THE APPLICATION OF CONTRACTOR IN BANK OF ARIZONA V. NATIONAL SURETY CORPORATION AND CALIFORNIA BANK V. UNITED STATES F. & G. CO., 129 F 2d 751, 752.

Application in B. of A. v. National Surety (R 127-130):

“(Contractor) hereby covenants . . . to indemnify the . . . (Surety) . . . against any and all liability, losses, costs, damages . . . and expenses . . . whatever . . . which (Surety) may sustain or incur by reason . . . of having executed or procured the execution of the bond¹ hereinabove applied for . . . and which (Surety) may . . . incur . . . in making any investigation . . . in obtaining . . . release from liability . . . such Bond.¹ (Paragraph 4th of Application - R129)

Application in California Bank v. U.S.F. & G. Co.

“(Anderson) hereby agrees . . . to indemnify the Company (appellee) against all loss, damages, claims, suits, costs and expenses whatever . . . which the Company may sustain or incur by reason of executing or procuring said bond,¹ or making any investigation on account of same . . . or settling any claim . . . in connection with same . . . and does hereby assign and convey to the Company as collateral to secure the obligations herein and any other indebtedness or liabilities

1. Such bond being to “guarantee the performance of (the Contract)” (R 127).

1. The bonds referred to in the applications were two performance bonds and two payment bonds. See note No. 3 129 F 2d at 752

(Contractor) hereby assigns, transfers and conveys to the (Surety) all the deferred payments and retained percentages, and any and all moneys and properties that may be due and payable to the (Contractor) at the time of any breach or default in said contract or that thereafter may become due and payable to the (Contractor) on account of said contract; or on account of extra work or materials supplied in connection therewith hereby agreeing that such money, and the proceeds of such payments and properties shall be the sole property of the (Surety) and to be by it credited upon any loss, cost, damage, charge and expense sustained or incurred by it in connection with said Bond.¹ (Paragraph 7th of Application R-129)

of (Anderson) to the Company, whether heretofore or hereafter incurred, all the right, title and interest of (Anderson) in and to (a) said contract, and any change, addition, substitution or new contract (including all retained percentages, deferred payments, earned moneys and all moneys and properties that may be due or become due under said contract, change addition, substitution or new contract) . . . such assignment to be effective as of the date of the construction contract, but only in event of (1) any breach of any of the agreements herein contained or of said contract or performance bond or of any other bond executed or procured by the Company on behalf of (Anderson) . . .”

1. Such bond being to “guarantee the performance of (the Contract)” (R 127)

